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In This Issue:

SEC Finally Proposes Modernized Investment Adviser Advertising Rule

By Michelle Canela, Genna Garver and Kurt Wolfe

This article was originally published in the November 2019 issue of Currents

It has finally happened! The U.S. Securities and Exchange Commission (the "SEC" or the "Commission") has delivered on its promise to modernize its rules on investment adviser advertisements. On November 4, 2019, the SEC proposed for public comment amendments to Rule 206(4)-1 under the Investment Advisers Act of 1940 (the "Advisers Act"), which governs investment adviser advertisements (the so-called Advertising Rule).

In today's hi-tech world of websites and social media platforms, the current version of the Advertising Rule is nearly impossible to implement, and firms find themselves doing somersaults to apply the rule to modern advertising media. According to the SEC, the proposed amendments to the Advertising Rule update the rule "to reflect changes in technology, the expectations of investors seeking advisory services, and the evolution of industry practices."[1] Because the Advertising Rule has not been amended since it was adopted in 1961, the updates are much-needed.

In this article, we highlight significant aspects of the proposed amendments to the Advertising Rule (the "proposal"), consider how those amendments might be received by compliance and legal professionals, and propose next steps firms should consider as they begin to think about how to develop a compliance framework around a final rule that is substantially like the proposal.

The Proposal

The proposal would replace the current rule with a less prescriptive, principles-based approach. While the proposal incorporates notable similarities to the current rule (e.g., general prohibitions on certain advertising practices), it also includes several important changes (e.g., a more permissive approach to the use of testimonials, endorsements, third-party ratings, and performance information).

In many respects, the proposal reflects language and concepts that have developed over the past several decades through SEC guidance, no-action letters and enforcement cases interpreting the application of the Advertising Rule. The proposed rule would apply to all investment advisers registered, or required to be registered, with the Commission—as with the current rule, the proposed rule does *not* apply to exempt advisers.

The proposal is organized as follows: (1) general prohibitions of certain advertising practices applicable to all advertisements; (2) restrictions or conditions on certain advertising practices (e.g., testimonials, endorsements, and third-party ratings) applicable to all advertisements; (3) requirements for the presentation of performance results, based on the advertisement's intended audience; and (4) a compliance requirement that most advertisements be reviewed and approved in writing by a designated employee before dissemination.

We consider those elements in order below. First, however, we discuss the new definition of "advertising," which meaningfully diverges from the current rule.

Definition of "Advertising"

A shortcoming of the current rule is its narrow definition of "advertising," which targets only outmoded forms of communication and does not contemplate modern advertising media. The proposal would create an evergreen definition of "advertising" that captures modern forms of communication and is flexible enough to remain relevant as technology and industry practices evolve.

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1. *SEC Proposes to Modernize the Advertising and Cash Solicitation Rules for Investment Advisers,* SEC Press Release 2019-230 (Nov. 4, 2019), https://www.sec.gov/news/press-release/2019-230. The SEC also proposed related amendments to Form ADV that are designed to provide additional information regarding advisers' advertising practices, and amendments to the Advisers Act books and records rule, Rule 204-2, related to the proposed changes to the advertising and solicitation rules.

Specifically, the proposed rule defines "advertisement" as "any communication, disseminated by any means, by or on behalf of an investment adviser, that offers or promotes the investment adviser's investment advisory services or that seeks to obtain or retain one or more investment advisory clients or investors in any pooled investment vehicle advised by the investment adviser." By replacing the current rule's references to certain media (e.g., television and radio) with a definition that applies to advertising delivered "by any means," the proposal's definition will remain evergreen in the face of changing technology.

Importantly, under the proposal, the definition of "advertisement" would *not* include: (1) live oral communications that are not broadcast, (2) responses to unsolicited requests for specified information about the investment adviser or its services, unless the response includes actual or hypothetical performance results, (3) advertisements and other sales literature that is about a registered investment company or a business development company and is within the scope of other Commission rules, and (4) information required to be contained in a statutory or regulatory notice, filing, or other communication. These are potentially significant carve-outs, as they allow some flexibility in communicating with current or prospective clients, and eliminate the need to review and approve certain categories of communications and sales literature, which will be much appreciated by compliance officers already overwhelmed with reviews.

General Prohibitions

The current rule prohibits certain advertising practices, and incorporates a "catch-all" provision that prohibits the publication of any advertisement that contains false or misleading statements of material fact. Similarly, the proposal includes "general prohibitions" that would comprise *per se* violations of the Advertising Rule. Taken together, the general prohibitions proscribe the dissemination of advertisements that contain false or misleading statements or omit key information—largely conforming to the goals of the current rule.

Specifically, under the proposal advertisements may not include:

(1) *Untrue statements of material fact or omit material facts, the absence of which make an advertisement misleading*. For example, advertisements may not that suggest a report, analysis or other service will be furnished free of charge unless the analysis or service is, in fact, offered for free and without condition.

(2) *Material claims or statements that are unsubstantiated*. For example, advertisements may not include statements about guaranteed returns or claims about the adviser's skills or experience that cannot be substantiated. Like the current rule, this prohibition likely includes false or misleading statements that any graph, chart, or formula can by itself be used to determine which securities to buy or sell.

(3) *Untrue or misleading statements that imply, or that might reasonably cause one to infer, a material fact about an investment adviser*. For example, advertisements may not include a series of statements that are literally true when read individually, but whose overall effect might create an untrue or misleading implication about the investment adviser.

(4) *Discussions of potential benefits of the adviser's services or methods without clearly and prominently disclosing any material risks or other limitations*. This would include any advertisement that discusses or implies any potential benefits connected with or resulting from an investment adviser's services or methods of operation without clearly and prominently discussing associated material risks or other limitations associated with the potential benefits.

(5) *References to specific investment advice provided by the investment adviser that is not presented in a fair and balanced manner*. This should be understood as an anti-cherry-picking provision. The proposal is, however, less restrictive than the current rule, insofar as it declines to prescribe exacting requirements for advertisements that highlight past specific performance. This provision is the successor to the current prohibition on past specific recommendations, and represents a departure from the current rule.

(6) *Performance results in a manner that is not fair and balanced*. Like references to past investment advice, this anti-cherry-picking provision is a more malleable, principles-based prohibition.

(7) *Statements that are otherwise materially misleading*. This prohibition is, for all intents and purposes, the proposal's version of the current rule's "catch-all" provision.

Conceptually, these prohibitions align with principles in the current rule, but they include notable new language or standards (e.g., the requirement that risks and limitations be presented "clearly and prominently" or that references to past advice be presented in a manner that is "fair and balanced") for which additional guidance will likely be needed to give advisers comfort that they are doing enough to satisfy their compliance burden.

Testimonials, Endorsement and Third-Party Ratings

At its core, the current rule is designed to prevent cherry-picking. To that end, the current rule includes restrictions on the use of testimonials, endorsements and third-party ratings—though those restrictions have been loosened over time through no-action letters.

This is an area where the proposal meaningfully breaks from the current rule. Indeed, the proposal would permit testimonials, endorsements and third-party ratings, provided certain disclosures and other safeguards are in place.

For purposes of the proposal, "testimonials" and "endorsements" are broadly construed to include an investor's experience with the adviser or its advisory affiliates (testimonial), and a non-investor's approval, support, or recommendation of the adviser or its advisory affiliates (endorsement). Permissible third-party ratings include only ratings that are conducted in the ordinary course of business by persons who are in the business of providing ratings or rankings.

The use of testimonials, endorsements and third-party ratings requires disclosure of: (i) the nature of the relationship with the party that provides a testimonial, endorsement or rating; (ii) any compensation provided to that party in exchange for the testimonial, endorsement or rating; and (iii) in the case of a third-party rating, information about the party who tabulated the rating and when it was completed. Testimonials, endorsements and third-party rankings that satisfy these prerequisites must still observe the general prohibitions discussed above.

As under the current rule, some testimonials, endorsements or third-party ratings may fall outside the scope of the rule. Importantly, the proposal instructs that third-party posts to an adviser's social media page are *not* subject to the rule *unless* the adviser took steps to influence the posted content or commentary.

Performance Results

The proposal would create a principles-based approach to the use of past performance in advertisements. Rather than enunciating circumstances in which it is *per se* appropriate to include past performance, or prescribing disclosures or legends that must accompany such performance information, the proposal would direct advisers to independently evaluate the facts and circumstances around the performance information in an advertisement—including any assumptions or factors that contributed to the performance—and include disclosures or other information they deem appropriate to ensure that the advertisement does not violate the general prohibitions.

The proposal's restrictions on the use of performance results largely reflect guidance from past no-action letters. It is worth noting, too, that the framework set out in the proposal aligns with the CFA Global Investment Performance Standards ("GIPS") and references GIPS several times in the release. Indeed, there is an implication that if a firm is GIPS compliant, it will likely comply with conditions enunciated in the proposal. As such, firms should consider the following GIPS guidance and restrictions:

- statements inferring that the calculation or presentation of performance results has been approved or reviewed by the Commission are prohibited;
- advertisements presenting gross performance must provide or offer to provide a schedule of fees and expenses deducted to calculate performance;
- advertisements presenting related performance must generally include all related portfolios (i.e., portfolios with substantially similar investment policies, objectives and strategies as those of the services being offered or promoted);
- advertisements presenting extracted performance must provide or offer performance results of all investments in the portfolio from which the performance was extracted;
- advertisements that present hypothetical performance must ensure that the hypothetical performance is relevant to the financial situation and investment objectives of the person to whom the advertisement is disseminated, provide sufficient information to enable such person to understand the criteria and assumptions

made in the calculation of the hypothetical performance, and provide or offer to provide sufficient information to enable such person to understand the risks and limitations of using the hypothetical performance in making investment decisions.

With respect to the use of performance results, the proposal also draws important distinctions between advertisements directed at retail investors and advertisements directed at non-retail investors who are "qualified purchasers" or "knowledgeable employees" (as those terms are defined under the Investment Company Act of 1940, as amended, and the rules thereunder). For example, retail advertisements may include gross performance *only if* net performance results are also included with at least equal prominence and in a format designed to facilitate comparison. The proposal would require performance results of any portfolio or certain composite aggregations across one, five, and ten-year periods.

Advertisements directed at non-retail customers, on the other hand, may include gross performance calculations *without* corresponding net performance results *if* the adviser offers to provide promptly a schedule of fees and expenses that would allow a non-retail investor to calculate net performance.

Review and Approval

The proposal also requires advertisements to be reviewed and approved in writing before dissemination. Advisers may designate one or more employees to provide the required review and approval—which should include legal or compliance personnel. Wherever possible, the person who creates the advertisement should not be the same person who reviews and approves its use.

The review and approval requirement would not apply to advertisements that are: (1) disseminated only to a single person or household or to a single investor in a pooled investment vehicle; or (2) live oral communications broadcast on radio, television, the internet or similar media. However, scripts, storyboards, or other written materials prepared in advance of live oral communications must be reviewed and approved if those materials otherwise meet the definition of "advertisement."

Assessing the Proposal

Given the levels of anticipation and excitement around the promise of amendments to the advertising rule, we expect many industry participants to comment. The proposal would significantly alter the advertising rule from a prescriptive framework to one that is principles-based. There are several new features that compliance and legal professionals must consider carefully, including elements that will be well received by advisers and, undoubtedly, elements that will create challenges for compliance teams.

On the whole, the proposal appears to be a win for marketing teams. Importantly, the proposal would allow the use of testimonials, endorsements and third-party ratings, in certain circumstances; the proposal would also permit references to past advice and gross performance, subject to certain disclosure requirements.

However, the proposal also provides scant detail on policies and procedures compliance officers will need to develop and implement to take advantage of the changes, and developing a compliance framework around a final rule will be no small task. Indeed, the rule will create a considerable compliance burden for compliance officers who will have to make sure their compliance framework aligns with the disclosure and other requirements in an imprecise, principles-based advertising regulatory environment created in the proposal. Compliance challenges will likely derive from the following: (i) time and resource constraints that could hamper a firm's ability to develop and implement policies and procedures around the new advertising rule, (ii) interpreting and deploying a principles-based (non-prescriptive) regulatory approach that leaves open questions about how to operationalize the new rule, and (iii) developing mandatory new work flows for which there is little guidance (like the required review and approval process for ads).

The greatest challenge with a principles-based approach is lack of certainty. Without further guidance, it will be difficult to develop and implement policies and procedures around the new ambiguous terms of art like "clear and prominently," "fair and balanced," and "materially misleading." The most pertinent aspects of the proposal that beg for clarity include the following:

- For purposes of the definition of "advertising," when will a communication by an unaffiliated third-party be "***by or on behalf of***" an adviser? And how will that interpretation impact interactions through social media?
- With respect to advertisements that discuss or imply potential benefits from an adviser's services or methods, what will satisfy the requirement that materials risks and other limitations be disclosed "***clearly and prominently***"?

- With respect to the catch-all provision in the general prohibitions, how will the Commission interpret and enforce the "***materially misleading***" standard?
- With respect to testimonials, endorsements and third-party ratings, how will advisers demonstrate their "***reasonable belief***" that certain disclosures were made by third-parties?
- With respect to the conditions around the use of past specific recommendations, what will satisfy the requirement that the investment advice be presented "in a manner that is ***fair and balanced***"?

Some of these concepts are addressed in existing guidance, no-action letters and enforcement actions as well as in other aspects of the federal securities laws. But there now exists uncertainty around the viability of no-action letters and other related guidance. Indeed, the proposal indicates that the Staff is considering which no-action letters and other guidance should be withdrawn or will otherwise be considered moot, superseded or inconsistent with the rule. The risk is that without further guidance or clarity around the meaning or interpretation of those concepts for purposes of a new rule, *compliance teams will have insufficient information to develop policies and procedures reasonably designed to prevent fraudulent or misleading advertisements.*

The risks associated with a lack of clarity are exacerbated by uncertainty around the viability of no-action letters and other related guidance. The proposal indicates that the Staff is considering which no-action letters and other guidance that address the application of the advertising rule should be withdrawn or will otherwise be considered moot, superseded or inconsistent with the rule.

The lack of regulatory clarity may be particularly detrimental in the context of a mandatory review and approval process in connection with which designated compliance or legal professionals will have to make judgement calls about whether a particular ad, script or promo satisfies an untested, principles-based regulatory regime. (For compliance teams that already have backlogs of marketing reviews, this added burden will not be well met.)

SWOT Analysis

In assessing the thrust of the proposal, and how your firm will operationalize its principles, we believe an analysis of strengths, weaknesses, opportunities and threats (a "SWOT analysis") may be instructive in forming a strategic plan for implementation of the final rule, when adopted.

While a SWOT analysis must be completed at the firm level, we believe there are common threads that compliance and legal professionals who are thinking about how to develop a compliance framework should consider. For purposes of this article, we have charted our (preliminary) thoughts on the strengths, weaknesses, opportunities and threats that will broadly impact firms and the investment advisory landscape.

Advertising Rule SWOT Analysis

S	**Strengths** ▶ Consistency with prevailing advertising regulatory concepts ▶ Compatible with existing GIPS frameworks ▶ An evergreen definition of "advertising"	**W**	**Weaknesses** ▶ Compliance burden to satisfy disclosure and other requirements ▶ Aspects of the rule might be difficult to operationalize ▶ Limited guidance around mandatory review and approval process, including factors to satisfy antifraud obligations ▶ The proposal lacks guidance for exempt reporting advisers
O	**Opportunities** ▶ Advertisements may include testimonials, endorsements and third-party ratings ▶ Clarity around endorsements on social media and similar channels ▶ Advertisements may include past investment advice, gross performance and hypothetical performance results	**T**	**Threats** ▶ Terms of art are vague or undefined ▶ Viability of past no-action letters and other guidance is uncertain ▶ Increased exam risk profiles with new Form ADV disclosures ▶ Increased risk of regulation through enforcement risk

Potential Next Steps Relating to the Proposal

Although the amendments to the Advertising Rule are still out for comment, in the coming months, firms should consider the potential scope of the rule and how they might design and implement policies and procedures around a new principles-based approach. This assessment will better position firms to prepare and submit comment letters, or to gear up for the process of implementing the final rule next year.

As noted above, the SEC has requested numerous comments on the Proposed Rule. The comment period is open now and will remain open for 60 days after the Proposed Rule is published in the Federal Register. The SEC has proposed a one-year transition period from the effective date of the final rule, if adopted.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm or its clients. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

The Business Case of Diversity and Inclusion

By Julia Ulloa

This article was originally published in the March 2019 issue of Currents

What is Diversity?

Diversity means understanding that each individual is unique and recognizing differences. Diversity has many layers which include, but are not limited to, race/ethnicity, gender, age, socioeconomic status, language, sexual orientation, and ability.

What is Inclusion?

Inclusion is respecting the difference. Being able to share one's ideas, having one's voice heard and bringing one's whole and authentic self to work.

Who are We?

The D&I Committee is a new NSCP working committee comprised of member volunteers.

Why do we Exist?

The D&I Committee exists to promote diversity and inclusion in the compliance profession while promoting the removal of bias. The D&I Committee aims to raise awareness of diversity and inclusion through NSCP educational programs, publications and meetings.

What is the Business Case for Diversity and Inclusion?

In 2018, Lisa Crossley, Executive Director of NSCP, launched a Diversity and Inclusion Committee ("D&I Committee") after identifying a void within NSCP. The mission of the D&I Committee is to promote diversity and inclusion in the compliance profession. As Lisa Crossley stated, "Associations play an important role in advancing diversity and inclusion among their individual member firms. They also have the power to affect diversity and inclusion across the professions they serve. Cultural shifts cannot happen without clear goals and processes. The NSCP recognizes that greater participation by diverse contributors can solve problems more creatively and identify growth opportunities that the association might otherwise miss."

Organizations such as McKinsey & Company have long debated the effect of diversity and inclusion on business outcomes. McKinsey has conducted diversity examinations for several years. The result of its examinations have evidenced that diversity boosts innovation, creativity and employee engagement which leads to improved revenue, and additional or more satisfied clients. With a direct impact on its bottom line and to maintain a competitive advantage, companies are weaving diversity and inclusion into day-to-day operations. From the hiring and retention processes to compliance functions, diversity and inclusion plays an integral part in today's corporate culture.

From a hiring perspective, a diverse workforce signals an attractive work place for talent and gives companies a competitive advantage. Studies have shown that diverse teams are well managed and productive.

From a compliance perspective, when a company puts emphasis on diversity and inclusion, it promotes a dialog of diverse ideas and exchanges. Diversity and inclusion lead to a safe environment where questions are asked and answered. Employees that feel comfortable discussing different ideas are more likely to report compliance issues when they arise.

READ THE FULL ARTICLE IN THE MARCH 2019 ISSUE OF CURRENTS

About the Author

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Valuation Challenges in Private Equity and Private Equity Real Estate

By Leslie Green

This article was originally published in the April 2019 issue of Currents

Valuation remains a focus area of the SEC, with the topic appearing consistently on initial request lists for advisers of all sizes. So why is it so important? It fits nicely into multiple focus areas of the regulator. The SEC is pushing hard on transparency and accurate disclosure to clients, as well as appropriate fee and expense calculations, ultimately working toward their "protection of retail investors" goal.

Simply put, inflated valuation marks lead to inflated performance projections, which ties directly to deal flow and a firm's ability to fundraise. Perhaps even more importantly, inaccurate valuations can lead to inaccurate fee calculations, another major focus area of the regulators. Within the private equity space, valuation processes are especially scrutinized. With no one specific method adopted or even applicable across all facets of the private equity space, valuation becomes an easy target, and can be a difficult process to manage if not a focus within your organization.

Valuation Methodologies

The most common private equity fair valuation methods are the (1) "market" or "comparison" approach, (2) the "income" approach, and (3) the "cost" approach. These are each widely recognized methodologies, but no one is necessarily considered more accurate than another. Instead, firms choose the most appropriate methodology based on the information they have available on a specific investment, and that investment's surrounding circumstances. With any fair valuation, firms should have a solid understanding of the metrics used to calculate the initial value of an investment. In addition, firms should be proactive in considering the inputs that could lower a valuation from its initial calculation and get comfortable with those, should those events come to pass. Fair values are typically assessed quarterly, so the initial valuation is crucial for accurate incorporation of any changes to inputs and assumptions used in the models based on the market and any observable events.

The most important factors in valuation are *reasonable accuracy* and *consistency in process*. Private equity valuations many times lack the abundance of public or readily available information for their basis, and therefore the need for transparency in each calculation is essential. In the event that there is not direct information on an asset, firms should use the most realistic comparable assets, markets, and other related information available to form the basis of their evaluations.

Third-Party Valuation Services

When readily available information is at a minimum or in other challenging circumstances, many firms should consider using third parties to assist with the valuation process. Third party valuations are a great option, and may provide some level of consistency of process, as well as greater access to a wider array of market and asset level data; however, they can't be taken as an end-all-be-all. Any processes surrounding the due diligence, use, and testing of third party valuation agents should be thoroughly documented within the firm's valuation policies and procedures.

In addition, firms who take this route should be prepared to defend their depth of analysis and understanding of these third party valuations. The use of these services typically begs the question as to whether a firm has done, or continues to do, its due diligence on the basis of each valuation. Firms are expected to not only be able to provide *assurance of reasonable due diligence on the third party evaluator, but also to demonstrate an understanding of the methodology* and inputs used by the third-party service to calculate each valuation. Furthermore, firms should consider performing some level of reasonable back testing on third party valuations to ensure they agree with valuations they receive. It is becoming increasingly common for regulators to perform their own back testing of valuation marks, in-house and third party, so any documentation of additional review firms can provide upfront

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will go a long way to support the thoroughness of their values. Recent examinations indicate regulators will not only review and scrutinize a firm's utilization of third party valuations, but even request direct interviews with any auditors or valuation agents, questioning inputs used during annual audits.

Trends in Private Equity Affecting Valuations

In the current environment, private equity returns have been at and near record highs. Because of this, not only are investors seemingly allocating more to private equity, but there is a significant amount of dry powder remaining, so many firms are chasing deals to keep up with fundraising activity. In addition, firms are under an inherent pressure in the industry to perform, and as a result, valuations have been increasing. Firms need to be extremely careful in how they are valuing assets and how they are using those performance track records to attract investors. Valuations used to market to clients should be consistent with the valuations recorded internally, and firms should be very transparent with clients if valuation methodology changes at any point during the life of an investment.

A good example of this upward trend in private equity activity can be readily seen in the real estate markets which have experienced a period of exciting returns over the last few years. When operating in the private equity real estate space, these firms are faced with the same sort of valuation challenges as the rest of the private equity realm. In fact, fair valuation of tangible real estate assets can introduce even more variables into the equation.

Tangible real estate assets are often less liquid than other asset types, with their valuations typically most comparable to a level three valuation of securities not actively trading on an open market. If investors are seeking liquidity, managers run the risk of investors looking elsewhere. In addition, if a property is overvalued, managers can run into risks in secondary transactions through (1) a decreasing likelihood of selling assets at higher valuations, and (2) risks in raising potential suspicion and investigation if they choose to pursue any sort of affiliate transaction in the sale of the investment. Demand inherently affects liquidity in this space, and less liquidity and less available market information often go hand-in-hand, increasing the subjective nature of the valuation calculations. Firms should take care not to overvalue their assets based on market optimism, rather than actual quality of their holdings.

Other Valuation Issues Affecting Private Equity Real Estate Advisers

Stages of Development

Valuing assets in the real estate space involves a significant level of subjectivity and judgement on the part of the firm. Real estate investment firms are faced with valuing their underlying properties at various stages of development. As properties move from initial valuation through development, stabilization, and marketing for sale, the inputs to the valuation calculations can change significantly. Valuation of stabilized assets, especially those already in the market for sale, are typically comparable to other existing assets in similar markets. Fair valuation, representing the assets exit price, can be more difficult to apply to an asset that is has not been physically completed or reached stabilization. Market inputs are not always readily observable or directly comparable to each asset, so firms must balance considerations, in addition to point in development, of things like current condition, property type, current sales market, economic trends, locations and demographics.

Because of the subjectivity of these variables, third party valuations may not be an ideal option in this space. That's not to say that third party data and market information do not help to inform each valuation, but real estate managers are reliant to a very large extent on the market expertise of their internal asset managers. The asset management team members are most familiar with the underlying properties and are in the best position to provide reasonable and current information on the property, the market, and the intangible market inputs that are not readily observable or do not have directly comparable information for each asset. Specific property information, in addition to those mentioned above (such as potential development delays, construction delays, management issues, supplier issues, weather issues, government red tape, unexpected local market and economic events), are monitored by each asset manager and become necessary inputs in accurate valuations of the property. Often times, asset managers find themselves reliant on relationships they've built in their industries, or contacts with boots on the ground in geographic locations they are monitoring, which can provide them with an excessive amount of private market information.

While this information can certainly inform their understanding of their assets, they must take special care to use verifiable inputs in calculations, as well as to protect sensitive information from clients while still maintaining transparency. In a fund structure, with multiple underlying properties, having properties within the same strategy does not equate to having the same available data for valuation inputs. The SEC looks for consistency in markets, especially in the private equity space, when analyzing comparables and ultimate valuations. This is not always easy or even possible in private equity real estate space. The sometimes drastic variance in the available data reinforces the importance of consistent and provable methodologies quarter over quarter.

Operation and Maintenance

In addition to this, real estate managers face operational challenges that are beyond that of a typical private equity fund, including expenses incurred which are not generally faced by other types of private funds. Transparency into fees and expenses has also become a focus area of the SEC, especially with respect to use of affiliates for any of these services. Depending on the point of development of the properties, firms are often responsible for property management and/or maintenance of its investment assets, as well as costs associated with the marketing and ultimate sale of the underlying properties. Real estate investments also encounter unique requirements for insurance, compliance with state and local codes and ordinances, and will usually be subject to property taxes and other ongoing taxes and assessments, which may need to be netted out for appropriate cash values.

Despite the challenges noted above, some of the best practices for firms are not surprising. Be thorough and realistic in establishing your processes; provide clear documentation; ensure your processes are being followed; and be prepared to test, explain and defend these processes.

Best Practices and Practical Takeaways

Firms must have clear and accurate policies and procedures in place for valuation methodology. Procedures should be reviewed frequently and by all parties involved in the valuation process to ensure consistency with actual practice. As discussed, consistency in methodology for all valuations is essential. Inputs vary, markets vary, but methodology should remain consistent and verifiable. In addition to this, valuation practices should be consistent with its application of any disclosures made to clients and investors.

Firm records should include clear backup documentation as to the selection of its valuation methodology. Be prepared to prove how your methodologies most accurately represent the valuation of your underlying assets. To the extent that methodologies differ from strategy to strategy, or asset type to asset type, this should be clearly stated, and changes to process should be disclosed as appropriate. Third party valuation agents should be thoroughly vetted, as should their methodologies, with this due diligence and monitoring processes documented completely within written procedures.

Firms must keep sufficient and appropriate documentation of all past valuations. Work papers, both internal and any third party, should be kept as back up. This includes any market or sales comparables used as inputs into its fair valuation models, as well as any rationale for changes made to discount rates that are used in calculations. If a methodology changes at any point, firms should have rock solid documentation and evidence of what has changed and the reasoning, to avoid raising suspicion that an initial calculation that resulted in a lower than desired value has been changed to obtain a higher result.

Finally, firms should also consider the implementation of a valuation committee to review and approve all valuations, quarterly and otherwise, as well as be prepared to discuss the specific role of the valuation committee and responsibilities of its respective members. Committees should have appropriate representation from interested departments, as well as supervision by senior management and a seat at the table for compliance to assist with oversight and mediating any conflicts. To do this successfully, compliance officers need to be educated on the ~~methodologies in practice and cognizant of what inputs and comparables are used, and whether or not what is being~~ used is actually realistic to the asset.

How to Best Work with Compliance Consultants

The following is an edited transcript of a recent NSCP-hosted webinar on how to best work with compliance consultants. Meghan Flanagan, Deputy Executive Director for the National Society of Compliance Professionals, introduced the discussion. Participants were Carlos Guillen, CEO, BasisCode Compliance, who served as moderator; Janaya Moscony, president, SEC3; James Spinelli, COO, Great Valley Advisor Group; Jon Wowak, COO, Cipperman Compliance Services; and Jason Ewasko, CCO, Cipperman Compliance Services. This article was published in the June 2019 issue of Currents.

Carlos Guillen: Today, we will be addressing with our panelists the following topics: why, how, and when is a good time to hire a third-party consultant, what to look for when finding the right consultant, what to expect related to cost, implementation, and timing, and leveraging consultants to evaluate other third-party relationships such as technology and other vendors. Janaya, when should a firm consider hiring a third-party compliance consultant?

Janaya Moscony: The right time to consider hiring a consulting firm is when you are starting a new firm and registering for the first time. Many people are unfamiliar with what's expected – especially from the SEC. During the preparation for registration, firms can gain an understanding for what they can manage in-house versus what they may need a consultant to help them with.

Firms often seek out a consultant when an internal CCO is leaving or there's some sort of transition internally. Here, a consultant is helpful to making sure you're getting all the information necessary from the departing employee and there's a smooth transition and excellent document retention. Compliance experts know what to request from that departing employee and sometimes it's helpful to have a third-party helping you through that transition.

Then there is the dual-hat situation which we find with a lot of partnerships and where consultants can help firms with ongoing compliance. Firms often find that using a consultant is cost-effective because they can have a firm officer internally maintaining the title and liability, but a consultant can do much of the heavy lifting. It helps with the independence perception since the CCO may be off and doing other activities with the firm, so it may create a conflict there.

Working with consultants who are ex-regulators or who have significant experience dealing with regulators can also be helpful in providing insight into FINRA and SEC expectations regarding disclosures, your policies and procedures, and your compliance testing.

Carlos Guillen: James, from the client perspective, can you talk about your experience on when to hire a third-party consultant?

James Spinelli: While our firm was already offering compliance as part of our value-add to advisors and our clients, and we actually felt comfortable with the solution that we were providing as a firm, we addressed this question after we experienced our first SEC exam and audit. We regrouped at the stakeholder level and said, "Do we have to add another layer to the program?"

We considered what teams are available out there, someone who specializes in compliance that could better help us prepare the compliance arm or the individuals that reside within that compliance arm of the firm. Then there are the situations when you add another element into the firm such as an in-house money manager program, which we rolled out a couple years ago and start managing models. That requires a different layer of compliance.

Lastly, using a consultant is really an independent validation of what you're currently doing, so we're able to validate the strength and weaknesses of the compliance program. It is what we didn't know that was pretty much the most concerning.

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Carlos Guillen: Jon, what types of work can a consultant do?

Jon Wowak: There's a lot that a consultant can do depending on the type of relationship and the priority of the client's needs. There's the fully outsourced CCO where the consulting firm would take on all compliance responsibilities and take a proactive approach to running the program. They may or may not have in-house compliance people working with them, but they're really in charge of the entire compliance program.

You can also build a support model to an in-house CCO or possibly a dual-hat person that will supplement the work of the compliance staff. If there's certain areas of need in the compliance department, the consultant can step in and do that work as instructed. It could also be project-based work, so as projects arise such as trade testing, mock audits and independent verifications.

Another area that consultant firms can be relied upon is short-term support during a CCO transition including medical leave, termination or separation. They can also do training and regulation adoption. Consultants can also administer compliance technology platforms such as BasisCode and others that are out there.

One of the latest areas of interest is cybersecurity. Compliance staff doesn't have the expertise to deal with the information technology side of their business and something that consultants are doing now is partnering or gaining that experience to bring the cybersecurity program from the SEC and FINRA's perspective in through compliance consulting.

Carlos Guillen: James, what should a firm like yours consider when hiring a consultant?

James Spinelli: The first and main thing is the reputation of the compliance firm and its principals. We did a lot of due diligence before we selected a consultant including looking at specialized teams which could help us out from our viewpoint.

The experience factor is extremely important as well. Our advisors and our clients trust us as fiduciaries. They want us to provide them with the most up-to-date industry information and be able to also handle unique situations.

Carlos Guillen: Janaya, can you please add to what the firm should consider when hiring a compliance consultant?

Janaya Moscony: The best consultants can do two things at the highest level. First, they can find the answers quickly. Secondly, they're reliable and diligent. Beyond these two fundamental qualities, there are so many other nuances that firms think are important and so consulting firms need to be flexible and offer customized service to their clients that meets their needs and specific requests.

In terms of due diligence, you should include asking questions related to the assigned consultant and checking references. While the firm reputation's is important, you also want to really dig into who you're going to be working with.

Consulting firms vary and so you need to make sure you are hiring a firm that meets your needs. Do you need a broker-dealer expert? Then, you want to be looking for a firm that has extensive broker-dealer experience. Do you need someone to assist you with registering an investment adviser? You want to be asking questions like "How many registrations has the consultant done? Is the new firm registering related to a multi-national firm and is it in need of participating affiliate letters?" In either case, you would want to have a consultant familiar with these matters.

Carlos Guillen: Jason, can you talk about how firms go about finding a suitable consultant?

Jason Ewasko: Centers of influence, such as industry attorneys and service providers like administrators and custodians, are key information and referrals sources for consultants. As far as the due diligence process is concerned, a buyer looking for a compliance consultant wants to make sure there's a fit. Without that, no matter how good the compliance knowledge may be, the relationship may not be great just because there's not a good personality or style fit.

Carlos Guillen: James, what was your experience with finding a suitable compliance consultant?

James Spinelli: There are a lot of out-of-the-box or cookie-cutter solutions available out there that need to be sorted out. After you go through the introductory phone calls, you ask the right questions, you understand who you're going to be working with, do they have the ability to understand what your firm is going to do and how to handle the agreements and filings as well as provide regulatory oversight. You then realize that while these out-of-the-box solutions may be well-priced, they're pretty much glorified Excel spreadsheets without having somebody dedicated to your firm or it's more of an 800 number.

Once you start adding different elements to your business such as financial planning, money management and perhaps fee-based 401Ks, those resources become limited and then you end up just having to reinvent the wheel and starting over.

Carlos Guillen: Janaya, can you discuss some of the doubts and concerns that firms have when hiring a consultant?

Janaya Moscony: Let's start with the inquiry of whether relying on a third-party might not be an accepted practice by a regulatory agency. The SEC will focus on whether you have a competent person at the helm and that the compliance program is being addressed. The SEC will also want to confirm that the tone at the top is accountability. If these essential elements are intact, using an external compliance person is completely acceptable.

Carlos Guillen: And the client's perspective, James?

James Spinelli: As Janaya said, a lot depends on the knowledge of those you are going to work with, the industry that you're in specifically and what you're trying to focus on. For instance, at Great Valley Advisor Group, we work with institutional clients and one of their main areas of interest is the RFP process. In that process, we frequently get questions on how does compliance work. They scrutinize the agreements and they ask, "We do see that you have a CCO and you do have in-house compliance analysts, but you're also utilizing a firm on the outside. What is that relationship like and do they really understand what you're doing?"

We explain to these clients how our consultant firm integrates with Great Valley with a level of additional oversight. We point out that not only are they going to get what we see, but they are also going to get access to what the consultant sees.

Carlos Guillen: Janaya, can you please discuss how to get the most value out of the services and expertise that consultants provide?

Janaya Moscony: First, you want to understand the contract and the deliverables. What is the scope of agreed services? I think sometimes there can be confusion because there's so many different offerings out there. You also want to look at your risk and, obviously, focus reviews to address the highest risk areas or areas maybe that you just don't have the expertise to address in-house. This requires a good understanding of what your employee's strengths and weaknesses are, where your consultant's strengths are and just understanding when to even call counsel versus calling a consultant.

Carlos Guillen: James, from your experience how does a firm maximize the contribution received from consultants?

James Spinelli: Set expectations early and often. Listen and understand what exactly you're getting yourself into and explain it to your team. From the beginning you want to communicate on issues with the consulting firm early and often. This is extremely important because the more you hide information, the worse it will be in the long run. Trying to hide an audit or something that happened in the past because you're afraid that it will be highly scrutinized, at the end of the day, it's usually not a good business decision.

Also, develop an integrated compliance calendar. If you already have one, edit and update it and stick to it. Work with the team to utilize whatever calendar they may have and go over new ideas or track ongoing daily, weekly, quarterly and annual tasks for the team – and see where those gaps are.

Carlos Guillen: James, can you speak to the value a consultant can bring to the firm?

James Spinelli: Having a regulatory exam pedigree is obviously very important. Are they familiar with key areas and what recent exams have occurred and what they focused on? Can they bring these elements to the table and understand who is going to be best prepared to answer those questions? Probably one of the biggest value-adds is just being aware of industry trends and what other firms are experiencing.

Carlos Guillen: Janaya, can you comment on the different types of engagements that firms can have with consultants.

Janaya Moscony: There's varying degrees of support that firms provide to clients but many of the packages or service lines look similar across firms. One area of service that the SEC has focused attention is related to outsourced CCOs. If we have a consultant that's acting as an outsourced CCO for a low risk, plain-vanilla firm, then we may allow them to take on a few more CCO roles.

The next level short of taking on the CCO title involves managing the compliance program, but not holding the title. This happens with firms where the person who was the CCO holds another title as well, like CFO, and they needed support for the compliance function. Several firms hire consultants to provide varying degrees of support where they may direct the program internally and have us or another firm supplement their programs with various tasks.

Carlos Guillen: Jon, can you talk a little bit about the differences between a fully outsourced consultant relationship and a consultant support engagement?

Jon Wowak: Between the fully outsourced model and a support model, the obvious difference is the level of proactiveness. With a fully outsourced model, there's a lot more skin in the game and liability over each aspect of the compliance program. The shift of liability from management and some of the compliance staff to an outside consultant is attractive to some of the firms that are not comfortable given their knowledge of compliance, the regulations and interacting with the regulators.

I think the most important thing when considering the differences between an outsourced and support model is you must make sure all of the stakeholders in your business plan are aligned. Then, ask how will you integrate and how will your compliance program be initialized, monitored and maintained?

After that, ask the consultant or the firm, from the fully outsourced perspective, how many times are you going to visit my office so that you can understand our business? How are we going to interact – through email, calls or video conferencing? Making sure that those interactions from the fully outsourced perspective truly outweigh the support model.

Carlos Guillen: Jason, can you discuss how consultants can assist firms in evaluating compliance technology and other vendor relationships?

Jason Ewasko: Whether it's technology providers or any other providers for that matter, prior experience is sort of the most basic way to find ones that you like and that you can put in front of a client. As a consultant dealing with a varied client base, we've had exposure to a wide number of relevant vendors, including a variety of tech vendors that would be suitable for the equally wide variety of firms that we deal with.

That's based on several considerations including the headcount of the client or the AUM. It could be they're tech-savvy and importantly it's often budget size. Speaking of budget size, it's a good segue into cost comparisons. It's not too difficult to find a group of vendors that are similar in terms of what they provide in terms of service offerings but it often comes down to cost.

Sometimes the trick can be what does the cost really looks like. For instance, there may be a set monthly fee or a set annual fee for those services, but there could be unadvertised startup costs at times or additional costs for add-on services as the relationship progresses. Having had some experience with that, we can push clients in the right direction to be on the lookout for those things and be able to make a smart decision.

It's also important to align the needs of the firm with the technology that's out there. A consultant can help effectively evaluate legitimate tech needs as opposed to getting the biggest list of technology services that sounds great on paper, but really may not be that relevant to what the firm needs.

We've seen some firms that are really interested in getting the "best technology" that's out there regardless of cost. More often, firms are looking for what it takes to get compliant in an affordable way and where they can feel they're set up well for an examination.

One of the largest barriers in assessing new technology is dealing with existing legacy systems. We've found that these systems need to be massaged to work with an enhanced compliance program, or new technology needs to be introduced into the mix. At times, the answer is to get rid of the old system, but we've seen situations where clients are really married to it for one reason or another and we work with them to make it all fit together in a way that is workable going forward.

The point that customization not being repeatable is important. We try to find systems and solutions that are repeatable without being purely off the shelf. Ideally, it's a standard solution that allows for some level of customization to make it work for the client, but also make it work for subsequent clients.

In terms of skill sets, most compliance consultants really don't have the technical expertise to provide a 100%, solid evaluation of a tech service's vendor. We educate ourselves as much as possible about the firms we're looking at to at least be in position to say, “Okay, these three or four are what you’re probably looking for within your price range; they offer the services,” and then it’s just a matter of finding a good fit.

Carlos, I guess it’s fair to throw it to you to see if you have any insights on what that process has been like.

Carlos Guillen: As a vendor who’s continuously being monitored by hundreds of firms globally – each with different requirements based upon their jurisdictions or their client types versus our RAs, BDs, banks whether they’re local or international – your comment regarding effectively managing a technology product requires a different skill set is valid. The product must continue to evolve to meet the new business requirements and provide continuous improvement while minimizing security risks.

One of the many value-added benefits that consultants provide to their clients is an external expert point of view. They ask the right questions on behalf of their clients to technology vendors. They have their ear to the ground as requirements change, new regulations emerge and as new risks appear. In our case, when consultants ask questions, we listen and adapt our platform.

Earlier, we discussed some of the doubts and concerns about bringing on or starting a consulting relationship. But what happens when you no longer require these services. Janaya?

Janaya Moscony: For consultants, this is part of the deal. You want to have a long-term relationship, obviously, with loyal clients. However, many firms also come and go for one reason or another. Maintaining a professional approach is vital to a consulting firm’s long-term success. It’s not just the firm that wants a peaceful transition for so many reasons, but the consultants prefer this too.

When this happens in any sort of situation, we generally try to make the transition easy for clients, so they know where their information is and how to access it. We meet with the new compliance person that’s taking over the program and we just try to make it a professional-type of relationship.

That way, the firm can change consultants without having to change the technology piece which affords peace of mind.

Simple Ways to Maximize Your Compliance Career At Any Level

By Shachi Bhatt

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A strong compliance program is only as good as the people who implement it. And if you are a member of a compliance department, you are probably surrounded by smart, confident, ethical professionals who work together to mitigate the risks across your organization. So, how do you stand out and get noticed? Well, whether you are just starting out or have many years of experience, there are several ways to make a noticeable impact in your firm's compliance department.

0-5 Years' Experience

Joining a compliance department can be a daunting experience. In addition to learning your job duties, you need to have a good understanding of your company's business and identify where potential compliance risks exist. By asking questions, speaking up when something looks unusual and seeking learning opportunities, you will become an invaluable part of the team – something to help you eventually get to the next level of your career.

Ask Questions!

It can be intimidating to ask questions, especially when you are in a compliance role which is often perceived to be the department with all the answers. This can be compounded if you are in a meeting where you fear asking questions might make you look uninformed. It is important to remember if you are just starting out in your compliance career it is entirely expected you will not know everything about every topic. Asking questions – avoid the "yes or no" kind – shows you are engaged, fearless and curious, three great traits that will help you grow in your role. Have a pen and notepad ready to note the response so you do not have to ask a second or third time. Later on, do a little more research on the internet to further familiarize yourself on the topic. Another tip – resist the urge to preface your question with "I have a question," or "sorry to ask a dumb question but…" It may not seem like it, but this undermines both you and your question.

Ready to ask questions but are not sure where to begin? Start simply by searching, "how to ask good questions in meetings" or "ways to ask for help in the workplace" on the internet. There are scores of wonderful tips to help you succeed.

Speak Up When Something Looks Unusual

Often newer compliance professionals are the first line of defense to identifying potential compliance breaches. In their roles, whether it be analyzing client reports, trade execution or marketing materials, they are the first set of eyes to review things. It is easy to assume someone else will notice it, but by highlighting an error or unusual activity you will demonstrate your issue-spotting skills and attention to detail. For example, if you review monthly invoices and one month the amount inexplicably triples, it is worth escalating it. Identifying and escalating an issue is a great first step and to grow even further, work with your supervisor to resolve the issue. Bringing a problem to your boss is great and shadowing or working alongside them to remedy that problem is even better.

Learn, Learn, Learn

Another common trait I see in successful compliance professionals is the ability to learn and understand the entire workflow of any given process. If, for example, you are tasked with monitoring portfolio trades to ensure no client investment guidelines were breached, make it a point to learn the overall lifecycle of a trade. In the future, this knowledge will not only help you identify where in the process an error might have occurred, but it will also help you make process improvements in the long run. Knowing how your overall business operates also helps you build relationships across various departments.

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5-10 Years' Experience

At the five year mark you have developed a core skill set in your area of compliance expertise. You have mastered the basics and now wonder how to move to the next level of your career. While every organization is different, there are a few ways to make a positive impact on your team and hopefully get noticed.

Find Solutions, Do Not Just Identify Problems

As you survey your professional skill sets, you probably realize that you are quite good at spotting issues. You escalate irregularities, errors and problems without any prompting and nothing misses your attention. To take this skill set to the next step, try your best to find solutions to the problems you have identified. Rather than simply highlighting an issue, create a plan on how to resolve it for your manager. They will be delighted to hear, "I have identified a problem and came up with a possible solution to fix it. Can we discuss them both?" Be ready to explain your thought process, how you arrived at the potential solution and what it will take to make it happen. Once the problem is remedied, write a brief email or memo to your boss summarizing everything. They will be grateful you took the time to thoughtfully document the issue. This extra step accomplishes two things – one, you have helped memorialize the resolution to a problem (which regulators and auditors always appreciate) and two, you have created your very own roadmap to help resolve the issue the next time it comes up.

You might be thinking, what if I do not have a solution to the problem? What should I do then? The best path forward in this instance is to be your supervisor's fact finder. You may not be able to fix it, but gathering all pertinent information shows you are engaged and ready to roll up your sleeves to help. This might include bringing them the following:

- What happened? (Be specific.)
- Who realized something was wrong?
- What has been done thus far to correct the error?
- Are there other departments involved? If yes, list everyone who is working on this issue.
- Any other facts that might be helpful in finding a solution?

Lastly, reiterate to your boss that you would like to be part of the solution. That looks like this:

"I want to learn how to solve increasingly complex problems, so I would really appreciate your help in figuring out the best way to solve this one."

Look For Process Improvements

Compliance is an ever evolving program. In order to stay ahead of the curve, it is important to constantly evaluate your department's processes and improve them where possible. This is where you come in. Whether it is streamlining workflows, implementing technology to automate tasks or just revising overall policies to better address the risks in your company, it is important to always be open to making things better. For example, do you maintain multiple databases or tracking spreadsheets with a lot of the same information? Propose a plan to consolidate and streamline them. In your plan, be sure to outline the risks and benefits involved so the decision makers in your organization will be well-equipped to review their options. Sometimes the least glamourous enhancements are the ones that transform the department the most, so do not be scared to start small.

10 Plus Years' Experience

If you are in this category, you have seen the compliance industry evolve dramatically through market cycles, new regulation and overall changes in doing business. You have a vast knowledge base which is perfect for advancing new compliance professionals. In order to take on larger, more challenging projects, you have to share your knowledge.

Teach Them To Fish

How many times has an employee walked into your office with a question and without hesitation you answer it? Be honest. When you are putting out multiple fires across your organization, it is very easy to solve your staff's problem, send them on their way and get back to work. While this might be more efficient for you in the short run, it is not fulfilling for you or your employees in the long run. Reflexively answering questions can be a hard habit to break, so try this – the next time someone comes to you with a question, pause for a full 3 to 5 seconds then ask, "what do you think we should do?" Give them a safe space to work through their possible solutions and encourage them to try one out. Do this consistently and you will find over time they will realize you are not going to hand them the answer, so they will come to you with a solution already in hand. When you practice one or all of these traits you are not only furthering your career, you are helping to build an exceptionally strong compliance program in your organization. One that values accountability, curiosity, problem solving and risk prevention.

Preparing for 2020: Steps to Implementing the 2020 Edition of the GIPS® Standards

By Amy Jones and Arin Stancil

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After years of development, the 2020 edition of the Global Investment Performance Standards[1] ("GIPS® standards") has been finalized. The 2020 GIPS standards become effective on January 1, 2020, which means that firms that voluntarily elect to claim compliance with the GIPS standards need to be prepared to implement policies and procedures that address the new requirements prior to that date. The reporting requirements have a longer timeline though – reports that satisfy the new requirements will not need to be created in most cases until 2021.

For firms that currently comply with the 2010 edition of the GIPS standards, there are several decisions that will need to be made as they convert to the 2020 edition. We organized a summary of the significant items that firms should consider as they perform their own gap analysis. This list is not comprehensive and firms that claim compliance with the GIPS standards should familiarize themselves with the full version of the 2020 GIPS standards. In addition, an Adopting Release letter[2] was organized by CFA Institute and is available on their website which serves as a useful tool for understanding the rationale for changes that were made and also provides some clarifying guidance.

GIPS Policies & Procedures

The most important task that firms that claim compliance with the GIPS standards should start with is reviewing their existing policies and procedures and preparing to make changes in order to align them with the 2020 GIPS standards by January 1, 2020.

A firm's policies and procedures must document how the firm has met all of the requirements of the GIPS standards. With respect to adopting the 2020 edition, this would include documenting policies for how the firm will address the new requirements. However, a firm is not obligated to establish policies to address requirements that are not applicable to them. For example, if the firm does not manage overlay portfolios, it is not necessary for them to outline procedures related to the calculation of overlay exposure.

> *Many of the changes introduce new options for firms to consider, rather than imposing strict new requirements.*

Many of the changes introduce new options for firms to consider, rather than imposing strict new requirements. As a result, there are not many mandated changes that will require changing existing processes, but firms will need to evaluate all of the changes to ensure that their GIPS program reflects how the firm decides to approach each applicable provision. For example, under the 2010 edition of the GIPS standards, firms are required to include all actual, fee-paying, discretionary "portfolios" in at least one composite. However, under the 2020 edition of the GIPS standards, firms will be required to include all actual, fee-paying, discretionary "segregated accounts" in at least one composite – with a segregated account being defined as a portfolio owned by a single client (i.e., not a pooled fund that is offered to multiple investors). This change does not mean that firms will need to remove all of their pooled funds from composites by January 2020, though firms will have the option of doing so if the fund's strategy is not offered to segregated accounts. There are several other changes made to provisions where firms are provided with additional flexibility and options; each firm will need to consider what the best approach is for them, then memorialize their decisions in their GIPS policies and procedures.

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1. https://www.cfainstitute.org/-/media/documents/code/gips/2020-gips-standards-firms.ashx
2. https://www.cfainstitute.org/-/media/documents/code/gips/adopting-release-firms.ashx

In addition, when reviewing policies and procedures, firms should also make amendments to terminology in order to mirror the 2020 edition. For example, "compliant presentations" are now referred to as "GIPS Reports." Firms should also update any references to specific GIPS provisions to reflect any changes in wording and to use new reference identifiers. For example, the concepts outlined in provision 0.A.9 of the 2010 edition are now included in provision 1.A.11 of the 2020 edition. Additionally, if the firm has incorporated disclosure checklists or other reference materials as part of their GIPS policies and procedures, these will need to be updated in order to match the revised requirements.

Takeaways for compliance professionals:

Compliance officers should confirm who at the firm is taking responsibility for updating the firm's GIPS policies and procedures and ensure that a timeline is established to finalize the updates prior to January 1, 2020 so that the firm is prepared to adopt the 2020 GIPS standards once they become effective. Firms may also choose to adopt the 2020 GIPS standards early – they do not need to wait until the year 2020 arrives. However, if a firm chooses to adopt the new GIPS standards early, they cannot selectively adhere to certain changes and not others.

Total Firm Assets

The 2020 GIPS standards clarify a couple of points with regard to the calculation of total firm assets (defined as the aggregate total of all discretionary and non-discretionary assets for which the firm has investment management responsibility). The first area of clarification is that total firm assets must not include advisory-only assets, which was previously not explicitly outlined in the GIPS provisions but was addressed through guidance published outside of the core GIPS standards and is already common practice throughout the industry. The other area that has been clarified relates to uncalled committed capital – assets that have been committed by investors but have yet to be called or drawn down by the investment manager. Beginning January 1, 2020, firms will no longer be permitted to include uncalled committed capital in total firm assets. The exclusion of uncalled committed capital has been applied less universally by firms to this point, so imposing this as a requirement will demand that some firms change their current practices. In any event, all firms should confirm how they have treated advisory-only assets and uncalled capital commitments for the purpose of calculating total firm assets historically and ensure that their practices align with the new requirements going forward.

Though advisory-only assets and uncalled committed capital cannot be included in the official total firm assets value that is reported in GIPS Reports beginning January 1, 2020, the 2020 GIPS standards introduce some new provisions that allow these figures to be presented as complements to or even combined with total firm, composite, or pooled fund assets. When combined totals are presented, the component figures must also be presented separately. For example, if a firm presents a combination of total firm assets and firm-wide advisory-only assets, the firm must also separately present total firm assets and firm-wide advisory-only assets for the same time periods.

Takeaways for compliance professionals:

Compliance officers should confirm if the firm is excluding advisory-only assets and uncalled capital commitments from the total firm assets values reported in GIPS Reports. Also, if these additional asset figures are presented separately, compliance officers should confirm that it is done in a manner that is consistent with the requirements of the GIPS standards.

Return Measures (TWR or MWR)

Up to this point, the GIPS standards have required the use of time-weighted returns (TWRs) in almost all cases, with the limited exceptions of private equity and closed-end real estate products. However, there are many instances where money-weighted returns (MWRs) are more commonly demanded by clients and investors, particularly for presenting performance of private funds. The need to align the reporting of such products more closely with standard business practice has been recognized and addressed in the 2020 GIPS standards, which allow much more flexibility for firms to report MWRs than previous iterations of the GIPS standards.

Going forward, the use of MWRs will not be limited to specific products or asset classes. Firms will have the option of reporting MWRs instead of TWRs in situations where the firm has control over the timing of external cash flows into the portfolios in the composite (or the specific pooled fund, if reporting on the pooled fund alone) and the portfolios also have one of the following characteristics: (1) closed-end, (2) fixed life, (3) fixed commitment, or (4) illiquid investments are a significant part of the investment strategy.

Firms that manage funds or strategies that satisfy these requirements will need to assess whether MWRs or TWRs are a more appropriate return measure to be presented. If the firm later decides to change the type of return presented for a particular composite or pooled fund, disclosure will need to be made in the GIPS Report regarding the change.

Additionally, for pooled funds and composites for which the firm is able to and chooses to report MWRs, the firm will also need to determine if a subscription line of credit – a revolving line of credit typically used by private funds to delay calling capital from investors – has been utilized. If so, performance will typically need to be presented both with and without the subscription line of credit. An MWR without the subscription line of credit assumes that capital was called to make investments rather than using the line of credit, so the calculation of the MWR begins with the first flow from the credit line rather than waiting for the first actual capital call. An exception to the requirement to present both sets of returns is allowed in instances where the principal borrowed from the subscription line was repaid within 120 days using committed capital and no principal was used to fund distributions, in which case only performance including the impact of the subscription line needs to be presented. For some firms, results without the subscription line of credit may not currently be calculated as a standard practice, so these firms will need to take steps to ensure that both sets of returns are readily available.

Takeaways for compliance professionals:

Compliance officers should confirm if there are any instances where the firm will present MWRs instead of TWRs in GIPS Reports. If so, then compliance officers who review these materials will need to confirm that disclosure checklists address the reporting requirements for presenting MWRs in GIPS Reports.

Lists of Pooled Funds

Under the 2010 edition of the GIPS standards, firms must maintain and make available to prospective clients a complete list of composite descriptions. Under the 2020 GIPS standards, firms will also need to create a list of limited distribution pooled fund descriptions and a list of broad distribution pooled funds, if the firm manages such funds. These lists have to be made available to prospective pooled fund investors upon request. Though the list of composite descriptions must include terminated composites for at least five years, the lists of funds do not need to include terminated funds.

Notably, unlike the other two lists, the list of broad distribution pooled funds does not need to include descriptions – it can be limited to just the names of the individual funds. The Adopting Release accompanying the 2020 GIPS standards also makes it clear that it is acceptable for the list of broad distribution pooled funds to be posted to a website and for the firm to direct prospective investors to the website if they request a copy of the list.

One aspect of the process of creating the fund lists is determining which funds managed by the firm qualify as "broad distribution" and which qualify as "limited distribution." In the glossary of the 2020 GIPS standards, broad distribution pooled funds are defined as a pooled fund that is regulated under a framework that would permit the general public to purchase or hold the pooled fund's shares and is exclusively offered in one-on-one presentations. On the other hand, a limited distribution pooled fund is simply any pooled fund that is not a broad distribution pooled fund. Limited distribution pooled funds were deliberately defined in this manner so that broad and limited distribution funds would be mutually exclusive – no funds managed by the firm should be considered both broad and limited distribution.

Takeaways for compliance professionals:

For firms that manage a large number of pooled funds, the process of creating the lists of funds – particularly the list of limited distribution pooled fund descriptions – may be an extensive exercise. With that in mind, compliance officers might be able to assist with compiling these lists by leveraging fund regulatory filings. Firms should determine the workload necessary to compile the list of broad pooled funds and the list of limited distribution pooled fund descriptions with the goal of having them completed prior to the end of 2019.

Firms should determine the workload necessary to compile the list of broad pooled funds and the list of limited distribution pooled fund descriptions with the goal of having them completed prior to the end of 2019.

Pooled Fund Reporting

Under previous editions of the GIPS standards, there were no specific reporting requirements related to prospective pooled funds investors, only prospective clients interested in a particular composite strategy. That has changed under the 2020 GIPS standards, which introduce a new requirement to make every reasonable effort to provide GIPS Reports to limited distribution pooled fund investors. If a firm manages limited distribution pooled funds, the firm will have a reporting obligation to provide prospective investors with either a GIPS Pooled Fund Report (which is a new concept under the 2020 GIPS standards) or a GIPS Composite Report for the composite that includes the pooled fund. Firms that have included their limited distribution pooled funds in composites will need to decide if they will continue to maintain composites for strategies that are not offered to segregated accounts. If so, they have to decide if the firm will produce a GIPS Composite Report or GIPS Pooled Fund Report for each of those strategies going forward.

When preparing for the production of GIPS Pooled Fund Reports, firms will need to determine who will be responsible for producing the reports. At some organizations, the fund and composite teams may be functionally or departmentally separated, so it may not be feasible or appropriate to have one team be responsible for creating both GIPS Composite Reports and GIPS Pooled Fund Reports.

When it comes to broad distribution pooled funds, firms do not have any obligation to provide GIPS-compliant information to prospective investors. Delivering GIPS Reports to prospective investors in broad distribution pooled funds is optional and not even explicitly recommended.

Takeaways for compliance professionals:

Firms that manage limited distribution pooled funds will need to confirm if a GIPS Pooled Fund Report will be provided to prospective investors or a GIPS Composite Report for a composite that includes the fund will be provided. In any event, a process will need to be established so that one or the other is provided. Compliance officers should confirm how these new reporting requirements will be implemented.

Firms that manage broad distribution pooled funds will need to make a business decision as to whether they will reference their claim of GIPS compliance in fund materials. If they elect to do so, they will need to follow the requirements of the GIPS Advertising Guidelines or provide a GIPS Pooled Fund Report – otherwise the materials should make no reference to GIPS compliance. Compliance officers should review materials to ensure they meet these requirements, when applicable, and that inappropriate references to the GIPS standards are not included in fund materials.

GIPS Reports

Once we move into the new year, firms will need to establish processes for creating GIPS Composite Reports and GIPS Pooled Fund Reports that meet the 2020 requirements. GIPS Reports do not need to be produced that meet the requirements of the 2020 GIPS standards until performance for periods ending on or after December 31, 2020 is included. However, it is anticipated that some firms will elect to implement the new reporting requirements earlier. Each firm should assess and determine at what point they will switch over to following the 2020 reporting requirements.

Following is a summary of amendments that will need to be addressed in existing presentations to meet the new requirements of the 2020 GIPS standards. This is not a comprehensive list and is only intended to highlight some of the changes that would be applicable to a majority of firm's GIPS Reports. In particular, there are several situational specific disclosures that firms will need to consider which are not captured below.

- New compliance statement for Verified Firms:
    - *[Firm Name]* claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. *[Firm Name]* has been independently verified for the period *[Dates]*. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report.

- CFA Institute trademark disclaimer:
  - GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.
- In addition to disclosing that a l*ist of composite descriptions is available upon request, disclose that a list of pooled fund descriptions for limited distribution pooled funds and a list of broad distribution pooled funds* are available, if applicable.
- Confirm total firm assets are reported as of each annual period end (presenting the composite assets as a percentage of firm assets is no longer an acceptable alternative).
- Disclose the composite inception date in addition to the creation date.
- Disclose whether internal dispersion (and any other risk measures presented) is calculated using gross-of-fees or net-of-fees returns.
- Ensure composite descriptions address each of the following, if applicable: (1) the material risks of the composite's strategy, (2) how leverage, derivatives, and short positions may be used, if they are a material part of the strategy, and (3) if illiquid investments are a material part of the strategy.
- Fee schedules must be customized to the intended audience, whether presenting to a prospective client for a standalone portfolio, a prospective client for a multi-asset strategy portfolio, a wrap fee prospective client, or to a prospective investor in a pooled fund. Specific to pooled funds, when presenting a GIPS Composite Report to a prospective investor for a pooled fund included in the composite, disclose the pooled fund's current fee schedule and expense ratio.

Additionally, several disclosure requirements were removed or relaxed, including:

- Firms may now indicate the reporting currency, rather than disclosing it (including the currency symbol would be sufficient).
- No longer required to disclose reasons for redefinitions to the firm or composites.
- No longer required to disclose reasons for changing a benchmark.
- Presenting the percentage of non-fee-paying assets is no longer required if using model fees to calculate net-of-fees returns.
- For composites that include wrap-fee portfolios, disclosing the various types of fees included in the wrap fee has been moved from a requirement to a recommendation.
- For composites that include wrap-fee portfolios, presenting the percentage of composite assets represented by wrap-fee portfolios is only required when presenting performance to a wrap fee prospective client.
- One-year sunset periods added allowing for the removal of disclosures related to:
  - Changes to composite names
  - Prospective benchmark changes
  - Significant events

Takeaways for compliance professionals:

Compliance officers who review presentation materials will need to confirm that the appropriate disclosures and statistics are included in GIPS Reports. This includes reviewing the disclosure requirements listed in the 2020 GIPS standards and updating disclosure checklists to reflect the requirements of the 2020 GIPS standards.

(continued)

Where to Start-Implementing the 2020 GIPS-Standards

GIPS Policies & Procedures

- [ ] Perform a gap analysis of the firm's existing GIPS-compliance program compared to the 2020 GIPS standards and reconcile any differences.
- [ ] Implement new policies and procedures to address new requirements that are applicable to the firm.
- [ ] Make decisions regarding new options introduced in the 2020 GIPS standards and memorialize those decisions in the firm's policies and procedures.
- [ ] Update terminology that has changed (e.g., compliant presentations should be referred to as GIPS reports).
- [ ] Update references to specific GIPS provisions to reflect any changes in wording and to use new reference identifiers (e.g., 2010 GIPS provision 0.A.9 equates to 2020 GIPS provision 1.A.11).

Total Firm Assets

- [ ] Determine whether advisory-only assets are currently being included in total firm assets.
- [ ] Determine whether uncalled committed capital is currently being included in total firm assets.

Return Measures (TWR or MWR)

- [ ] Determine whether the firm manages any portfolios where the firm has control over the timing of external cash inflows.
- [ ] For portfolios where the firm has control over the timing of external cash inflows, determine whether the portfolio also has one of the following characteristics: (1) closed-end, (2) fixed life, (3) fixed commitment, or (4) illiquid investments are a significant part of the investment strategy.
- [ ] For portfolios where the firm has control over the timing of external cash inflows and also has one of the characteristics noted above, determine whether money-weighted returns (MWR) or time-weighted returns (TWR) are a more appropriate return measure for the product or strategy.
- [ ] For funds and composites that will report MWR, determine whether subscription lines of credit have been utilized and if returns both with and without the line of credit are available.

Lists of Pooled Funds

- [ ] Determine whether funds managed by the firm qualify as "limited distribution" or "broad distribution" pooled funds.
- [ ] Create a complete list of the firm's active broad distribution pooled funds.
- [ ] Create a complete list of the firm's active limited distribution pooled funds, including descriptions for each fund (general information regarding the investment mandate, objective, or strategy of the pooled fund).

Pooled Fund Reporting

- [ ] Determine which pooled funds managed by the firm represent strategies that are managed for or offered as segregated accounts.
- [ ] Determine if composites will be maintained for pooled funds that do not represent strategies that are not managed for or offered as segregated accounts.
- [ ] For limited distribution pooled funds that are not included in composites, establish procedures for creating GIPS Pooled Fund Reports.
- [ ] For limited distribution pooled funds that are included in composites, determine whether the firm will produce GIPS Pooled Fund Reports, GIPS Composite Reports or both for the particular strategy.
- [ ] Implement process for providing GIPS Reports to prospective investors in limited distribution pooled funds.
- [ ] Establish procedures for determining whether new pooled funds will be included in composites prospectively

GIPS Reports

- [ ] Determine when the firm will convert to following the 2020 reporting requirements (for reports that include performance for periods ending on or after December 31, 2020 or earlier)
- [ ] Update your disclosure checklists to capture the new disclosure requirements that are outlined under the 2020 GIPS standards

Misleading Performance Advertising: The Risks of Portable and Hyphothetical Returns

By Robert Tull, CCEP, CFE, CPA, CSCP, FRM

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Performance advertising is an indispensable tool for investment advisers to attract and retain clients. As the marketplace and investment tools evolve, the needs for advertising performance returns also change, but the risks of being considered misleading remains the same. Advisers are more frequently considering the portability of performance histories and the use of hypothetical performance returns in response to these changes. Accordingly, this article will review how performance advertising is viewed in light of the "misleading" prohibition, and then summarize the conditions, concerns, and considerations associated with the portability of performance histories and the use of hypothetical performance returns.

"Misleading" Performance Advertising under the Advertising Rule

The use of advertisements by investment advisers is subject to Section 206 of the Investment Advisers Act of 1940 (the "IA Act"), the antifraud provision, and specifically Rule 206(4)-1 (the "Advertising Rule").[1] The Advertising Rule consists of four specific prohibited practices and one general catch-all prohibition.[2] The catch-all prohibition in Rule 206(4)-1(a)(5) prohibits any advertisement that contains any untrue statement of material fact or which is otherwise false or misleading. This "false or misleading" standard is applied through a patchwork of no-action letters and enforcement actions addressing specific scenarios.

Advertisements are expected to reflect the fiduciary principles, including fair dealing and operating in good faith. In this respect, advertisements should be fair and balanced, provide a sound basis for evaluating a security or service, and avoid any false or misleading statement or omission. Determining what could be considered "false or misleading" content is inherently subjective and depends on the facts and circumstances, including:[3]

- form and content of the advertisement;
- the adviser's ability to perform what is advertised;
- the implications or inferences of the communication; and
- the sophistication of the reader.

The types marketing content that could be considered false or misleading can be expansive, ranging from outright promissory statements regarding returns or past experiences, to the banal superlatives like "leading," "unique," "best in class," and "premier." Further, it can include the typical marketing gamesmanship of ultrafine print disclosures, muddled footnotes, and inconsistent reporting dates and periodicity. One essential piece of marketing content is perpetually perceived as potentially misleading: performance returns. The use of performance returns in advertising is generally considered misleading unless certain conventions are followed. With the variety of ways to present performance returns, there is an equally diverse array of no-action letters offering permitted conditions. Some cornerstone no-action letters include:[4]

- Clover Capital Management, Inc. (October 28, 1986, for advertisements containing model or actual performance); |
- J.P. Morgan Investment Management, Inc. (May 7, 1996, for advertisements containing performance returns with the deduction of model management fees);

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1. Rule 206(4)-1(b) under the IA Act defines an "advertisement" to include written communications addressed to more than one person, as well as any oral communications delivered via radio or television. The "advertisement" definition can be applied to electronic communications, such as a website or social media.
2. As listed in paragraphs (1) through (4), the Advertising Rule prohibits any advertisement that: (1) refers to any testimonial concerning the adviser, advice, analysis, report, or other service; (2) refers to any past specific recommendation which were or would have been profitable (unless the advertisement also makes available a detailed list of all recommendations made by the adviser within the prior one-year period); (3) represents that any graph, chart, formula, or other device being offered can, in and of itself, be used to make investment decisions without prominently disclosing the limitations and difficulties of using it; and (4) contains any statement to the effect that any report, analysis, or service is free unless it really is free or without charge.
3. *Clover Capital Management, Inc.* (October 28, 1986).
4. This list is by no means exhaustive.

- Investment Company Institute (September 23, 1988, for one-on-one advertisements containing gross-of-fees returns);
- Association for Investment Management and Research (December 18, 1996, for advertisements containing side-by-side presentation of gross-of-fee and net-of-fee returns);
- Horizon Asset Management, LLC (September 13, 1996, for advertisements containing performance returns from a prior firm); and
- The TCW Group, Inc. (November 7, 2008, for advertisements containing a balanced presentation of performance contributions from specific securities).

In addition to the no-action letters, guidance on required performance advertising practices can be gleaned from enforcement actions.

As articulated in the no-action letters and enforcement actions, the staff of the Securities and Exchange Commission ("SEC") considers an adviser's performance advertisement to be false or misleading "if it implies, or a reader would infer from it, something about the adviser's competence or about future investment results that would not be true had the advertisement included all material facts."[1] In *Clover*, the SEC staff outlined the foundational principles and conditions for advertising performance returns. Specifically, the use of model or actual performance results would be misleading unless the advertisement contains certain information and disclosures detailing:

- the effect of material market or economic conditions on the results;
- the deduction of advisory fees, commissions, and any other expenses that a client would have paid;
- whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings;
- all material facts relevant to comparing returns to an index;
- any material conditions, objectives, or investment strategies used to obtain the results portrayed;
- the potential for the possibility of loss;
- for model returns:
    - the inherent limitations, (particularly the fact that the results do not represent actual trading);
    - the conditions, objectives, or investment strategies of the model portfolio that changed materially during the time period and the effect of the change on the results;
    - that any of the securities contained in, or the investment strategies followed with respect to, the model portfolio did no not relate or partially relate to the type of advisory services currently offered by the adviser; and
    - that the adviser's clients had investment results materially different from the results portrayed in the model; and
- for actual returns, that the results portrayed relate only to a select group of the adviser's clients, the basis on which the selection was made, and the effect of this practice on the results portrayed, if material.

Performance returns are a key component of the "product" sold by advisers, and offering an updated and attractive product is a competitive necessity.

Performance returns are a key component of the "product" sold by advisers, and offering an updated and attractive product is a competitive necessity. Recent industry developments – such as mergers, acquisitions, and consolidations, and the incorporation of new investment tools and technologies in the investment process – have led firms to reinvent their image and consequently reimagine performance track records. Two particular approaches to recrafting performance advertising are demanding attention from compliance professionals and regulators alike: the portability of performance histories and the use of hypothetical or back-tested returns.

Portability of Performance Histories

When firms acquire experienced talent through acquisitions or the migration of investment personnel, a natural benefit is the desire to advertise the performance track record of the new personnel; this is the concept of portability. Performance histories can be "ported" from an entire firm (such as when one adviser acquires another), or from an individual or a team (such as when investment personnel join a new firm). In these situations, the adviser essentially takes credit for the returns achieved at a different organization and prior to the current organizational structure. The portability of performance histories would be misleading unless certain conditions are met, and the advertisement contained appropriate disclosures: At a minimum, the following conditions are required:[2]

5. *Clover Capital Management, Inc.* (October 28, 1986).
6. *Horizon Asset Management, LLC* (September 13, 1996).

- the personnel who will manage accounts at the adviser are also primarily responsible for achieving the prior performance history;
- the performance history does not include any period which pre-dates when the investment personnel began managing the accounts at the predecessor firm;
- the accounts in the performance history are sufficiently similar to the types of accounts currently under management at the adviser, or sought by the adviser (in order for the performance history to provide relevant information to such clients);
- the performance history includes all accounts that were managed in a substantially similar manner, unless the exclusion of any account would not materially inflate performance; and
- the adviser must have all the supporting books and records to substantiate the "ported" performance history.

In assessing whether the portability conditions are satisfied, common complications arise in the area of investment decision-making and supporting records. If the investment personnel claiming the performance history were previously part of a larger team, such as being supported by or supervised by other individuals that contributed to the investment decision-making, then it could call into question whether the investment personnel were "primarily responsible" for the performance history and thereby making an advertisement of such history potentially misleading. This situation is particularly complicated when the investment personnel were part of a team or committee and there was no clearly defined ultimate decision-maker. For firms encountering this, documentation from the prior organization summarizing the investment decision-making process, leadership, and the autonomy of investment personnel is key to substantiate the conclusion that the investment personnel had the requisite primary responsibility for the performance history.

Even when it is clear that the investment personnel were primarily responsible for the performance history, portability is complicated by the need for the supporting books and records to also be maintained at the adviser.[3] The transfer or duplication of records for the adviser requires the authorization and assistance from the prior firm and the relevant clients. When the departure of investment personnel is less than amicable and such approval or assistance is unlikely, it is possible for the adviser to obtain the necessary source records directly from the clients or public records (in the case of a mutual fund managed by the investment personnel); however, the computation worksheets for the returns will need to be re-created by the adviser. When clients and the prior firm do not provide authorization to transfer or duplicate the records, the adviser will not be able to include such accounts in the performance history. If the performance history only reflects a selected group of accounts, then the adviser must disclose the exclusion, the basis on which accounts were selected to be included in the performance history, and the effect on the performance history. The same holds true for when portability of the performance history involves the portability of client accounts included in the history and not all clients migrate to the adviser; absent having the records and permission, if clients do not migrate then the accounts will need to be excluded from the performance history.

The portability conditions are not necessarily insurmountable, but they are much easier to address if there is full continuity of the investment personnel, the investment strategy, the investment decision making, clients, and all supporting records.

The portability conditions are not necessarily insurmountable, but they are much easier to address if there is full continuity of the investment personnel, the investment strategy, the investment decision making, clients, and all supporting records.

Hypothetical or Back-Tested Performance Returns

The advent of new tools, technologies, and big data triggered changes in investment processes throughout the industry and created new client demands. In order to capitalize on these changes and new market demands, advisers often attempt to demonstrate how their organizations have responded by illustrating performance results incorporating these developments. This is primarily accomplished through hypothetical or back-tested

7. Rule 204-2(a)(16) under the IA Act requires that advisers maintain all accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations in any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly, to any person (other than persons connected with such investment adviser); provided, however, that, with respect to the performance of managed accounts, the retention of all account statements, if they reflect all debits, credits, and other transactions in a client's account for the period of the statement, and all worksheets necessary to demonstrate the calculation of the performance or rate of return of all managed accounts shall be deemed to satisfy the requirements of this paragraph.

performance (collectively, "back-tested performance"). Back-tested performance is synthetic performance generated by retroactively applying tools, data, and techniques to historical data as a means to prove a potential outcome for clients. Back-tested performance involves the benefit of hindsight, it does not involve actual trading or principal at risk, and it can be generated after multiple iterations of tweaking and finetuning factors to get a contrived result. In light of these considerations, back-tested performance is subject to skepticism and scrutiny, and the SEC views it as dubious and misleading.

Back-tested performance requires a tremendous amount of disclosure in order to be considered not misleading by its very nature. Essentially, all aspects of the back-testing should be disclosed in order to rise above the specter of being considered misleading. At a minimum, advisers utilizing back-tested performance in advertising will need to disclose:[1]

- the inherent limitations of calculating returns by retroactively applying a model or process developed with the benefit of hindsight;
- the assumptions, factors, and variables underlying the model or process;
- whether the model has changed materially over the time period presented;
- that the performance results do not represent actual trading or market risk;
- all material economic and market factors that might have impacted the adviser's decision-making when using the model or process to manage actual client accounts;
- whether the actual performance of client accounts was materially different than the back-tested performance for the same period;
- the reasons why actual results do and may differ from the back-tested performance;
- whether the strategies and investments used in the back-test were actually available to investors during the periods presented; and
- any material facts relevant to any index/benchmark comparison.

In short, the disclosures for back-tested performance effectively need to clearly state for clients and prospects that the returns do not reflect reality and are simply not achievable.

Furthermore, back-tested performance must still comply with the requirements for presenting model performance returns, which means the returns be net of commissions and other expenses, as well as net of management fees. Advisers can opt for deducting a model management fee equal to the highest fee associated with the back-tested strategy to present net of fee figures. A similar approach can be taken to present back-tested performance net of commissions and other fees, although this approach is not sanctioned any formal guidance.

Aside from the litany of disclosures necessary to present back-tested performance in a way that is not misleading, there have been several recent cases that also highlight the pitfalls of the back-testing process which could render an advertisement misleading. In one recent administrative proceeding, an adviser refined aspects of its back-testing process over time, and in each iteration, recalculated the back-tested performance and included the recalculated back-tested performance in advertisements. This hindsight-of-hindsight rewrote the back-tested performance history, thereby improving an already artificial return series. The revisionist history was not adequately disclosed, and neither was the fact that back-tested performance was used in advertisements instead of actual client performance for the same period.

In another administrative proceeding, an adviser's advertised back-tested performance reflected holdings and the timing of investments that were not consistent with the strategy or the management of actual accounts, and part of the back-tested performance was based on an index that investors could not actually invest in directly. These inconsistencies disconnected the back-tested performance history from both possibility and actuality, and were not adequately disclosed.

There is an understandable and natural tension between advisers desiring to illustrate the potential impact of new technologies, data, and techniques for clients and prospects to appreciate the competitive distinction offered by the adviser, and the risk of being misleading. Advertising back-tested performance is perilous and difficult, but it is not the only method for advisers to communicate the potential results of its services. As an alternative to back-tested

8. Derived from guidance in various enforcement cases, such as: In the Matter of Patricia Owen-Michael, Investment Advisers Act Release No. 1584, September 27, 1996. In the Matter of LBS Capital Management, Inc., Investment Advisers Act Release No. 1644, July 18, 1997. In the Matter of Schield Management Company, Investment Advisers Act Release No. 1871, May 31, 2000. In the Matter of Market Timing Systems, Inc., Investment Advisers Act Release No. 2047, August 28, 2002.

performance, advisers can advertise attribution or carve-outs for certain subsets of actual returns, or even specialty indices, all with appropriate and comprehensive disclosures. While both attribution and carve-outs have their own limitations, it is less cumbersome and more credible than back-tested performance, as it reflects actual performance.

Advertising performance returns – whether actual, ported from another firm, or back-tested – must still adhere to the fiduciary and anti-fraud principles, avoiding false or misleading content or omissions. The portability of performance histories must satisfy certain conditions and be presented with adequate disclosures in order to comply with the Advertising Rule. Similarly, but with less clarity, back-tested performance must be conducted in good faith and in accordance with the stated strategy, and must be presented with extensive and transparent disclosures in order minimize being labeled misleading or fraudulent by regulators.

CSCP: Certified Securities Compliance Professional

The Only Designation for Both Broker-Dealers and Investment Advisers

By Lisa Crossley

This article was originally published in the October 2019 issue of Currents

In January 2020, NSCP began offering a restructured Certified Securities Compliance Professional (CSCP) program in partnership with the University of St. Thomas. CSCP is a graduate-level program for experienced financial services professionals including service providers and regulators. Upon completion of the academic course and the CSCP certification examination, candidates will be granted the CSCP designation offered by NSCP.

Highlights of the CSCP certification program through University of St. Thomas:

- 14-week course delivered online
- Instructors are leading financial services industry professionals
- CSCP examination offered for BD, IA and Dual Registrants
- Discounted NSCP Membership
- Three graduate-level academic credits are awarded by the University of St. Thomas with successful completion of the course, which can be applied to the online MSL degree program in Organizational Ethics & Compliance
- Cost: $3,000 (Includes the CSCP certification exam fee)

Earning the CSCP designation will distinguish individuals with intermediate to advanced proficiency and a commitment to advancing securities compliance practices, lifelong learning, and professional development.

CSCP Certification Program Curriculum Includes:

- Creating and managing a compliance program, including risk assessments
- Developing, monitoring and testing policies and procedures
- Identifying conflict of interests and Code of Ethics provisions
- Processes regarding client communications
- Understanding recordkeeping and filing requirements

CSCP Certification Course Delivery Description:

- 14-week course delivered via video each week
- All course materials including readings and PowerPoint slides are provided via University of St. Thomas's online course site
- Five main learning sections divided into 14 modules
- On-line real-time and virtual office hours available to students

Eligibility Qualifications for the CSCP Certification Program:

- Bachelor's degree from an accredited college/university required. (Waiver available for qualifying students).
- Official transcripts from schools you have attended, including a final transcript from your undergraduate school showing that you received a bachelor's degree.

Although not required, it is strongly recommended that an individual have three or more years of professional experience in financial services compliance. The CSCP examination assesses intermediate to advanced proficiency in securities compliance rather than entry-level skills.

About the Author

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Securities compliance experience is defined as:

- Employment in the Compliance or Legal Department of a registered broker-dealer, investment adviser, or dual-registrant whether registered with the SEC or a State regulatory authority, or exempt from such registration; or
- Employment in the Compliance or Legal Department of a financial services firm that has a registered broker-dealer or investment adviser affiliate, with substantial job responsibilities supporting the brokerage or advisory services of the firm; or
- Employment with the SEC, FINRA, or another
- securities regulator or self-regulatory organization; or
- Practice at a law, accounting, or consulting firm, with a substantial part of your practice consisting of providing advisory, consulting or litigation support to the securities (broker-dealer or investment advisory) industry.

CSCP Designation Use Qualifications:

- A minimum of three years employment in the financial securities industry is required in order to use the CSCP designation
- Recertification bi-annually

CSCP Program Cost:

Tuition for the CSCP certification program is $3,000.00 including the CSCP examination.

Ready to Get Started?

To learn more about the CSCP program go to https://nscp.org/about-cscp

READ THE FULL ARTICLE IN THE OCTOBER 2019 ISSUE OF CURRENTS